Decision 89 12 045 DEC 18 1989

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Application of Southern California Gas Company to implement a firm capacity allocation contract with San Diego Gas & Electric Company by Advice Letter 1864, filed March 20, 1989.	(I&S) Case 89-05-016 (Filed May 10, 1989)
In the Matter of the Application of Southern California Gas Company to implement a firm capacity allocation contract with Southern California Edison Company by Advice Letter 1872, filed May 2, 1989.	
And Related Matters.	R.88-08-018 (Filed December 21, 1988) I.87-03-036 (Filed March 25, 1987)

(Appearances are listed in Appendix A.)

O P I N I O N

This decision addresses Southern California Gas Company's (SoCal) request for approval of two contracts, one with San Diego Gas & Electric Company (SDG&E) and one with Southern California Edison Company (SCE). Both contracts are for a range of gas services from SoCal.

SoCal originally applied for contract approval by filing advice letters. On May 10, 1989, we issued an order instituting an investigation and suspension of Advice Letter 1864 and Advice Letter 1872 which requested approval of the contracts. We initiated this investigation because of the many protests to the advice letters we received. Generally, the protests commented that the contracts prejudiced our resolution of issues in R.88-08-018 and raised equity issues.

Eight days of hearings were held in this proceeding. The case was submitted on August 23, 1989. The parties supporting the contracts were SoCal, SCE, SDG&E, and the City of San Diego. The parties opposing the contracts included the Division of Ratepayer Advocates (DRA), Toward Utility Rate Normalization (TURN), California Cogeneration Council (CCC), California Industrial Group and the California League of Food Processors (CIG), Cogenerators of Southern California (CSC), and Trigen Resources Corporation (Trigen).

This decision rejects the contracts as filed, but sets forth conditions upon which we would approve them. A number of provisions of the agreements SoCal negotiated violate previously articulated Commission policies or are inconsistent with sections of the Public Utility Code. This decision provides guidance to the gas utilities regarding modifications to these agreements and also general guidance on long-term contracts for which they may seek approval in the future.

In so deciding, we recognize and reconcile the tension between the short-term reliability needs of California and our long-term goals. These goals include continuation and expansion of the unbundling of gas services, and the development of a firm capacity allocation that is coordinated and consistent with policies of the Federal Energy Regulatory Commission.

I. The Contracts

A. Contract with SDG&E

SoCal's contract with SDG&E provides for all of SDG&E's gas service needs, including long-term price and service commitments for transportation and storage of SDG&E-owned gas, gas sales to SDG&E by SoCal, and firm interstate capacity rights. The initial term is five years. At the end of the second contract year and each anniversary thereafter, the contract would be automatically extended for an additional one-year period unless either party notifies the other of contract cancellation.

Specific elements of the contract include:

- <u>Demand Charges</u>. The demand charge during the first year of the contract will be $5.4 million per month. In subsequent years, the demand charge will be adjusted based on the percent change in SoCal's total non-gas costs as authorized by the Commission.

- <u>Transmission Charges</u>. The transmission volumetric rate during the first year will be $0.10 per million British thermal units (MM/Btu). In subsequent years, the transmission rate will escalate in the same manner as the demand charge.

- <u>Minimum Charge</u>. A minimum charge will be imposed quarterly based on the number of days in the quarter times 270 million cubic feet per day (MMcfd) times the transmission charge, plus the demand charge. This equates to a ninety percent "take-or-pay" on the transmission charge.

- <u>Intrastate Priority</u>. The priority for UEG volumes up to 125 MMcfd will be P-3.

- <u>Interstate Capacity</u>. Firm interstate capacity is provided for up to 300 MMcfd (225 MMcfd on El Paso and 75 MMcfd on Transwestern). This provision is subject to FERC approval of a compatible capacity program. Prior to this approval, a "buy/resale" arrangement will be implemented.

- <u>Storage</u>. The contract provides 12.7 billion cubic feet (Bcf) of storage. Additional storage volumes are available at the prices contained in the G-STOR tariff except for the reservation fee.

- <u>Portfolio Switching Ban</u>. The contract provides a waiver of the portfolio switching ban now in effect.

B. Contract with SCE

The contract with SCE provides all of SCE's gas service needs, including long-term pricing and service commitments for transportation, storage, and distribution of SCE-owned gas, retail gas sales to SCE by SoCal, and firm interstate capacity rights. The initial term is five years. At the end of the fourth contract year and each anniversary year thereafter, the contract is automatically extended for an additional one-year period unless either party notifies the other of contract cancellation.

Specific provisions of the contract include:

- Demand Charges. The demand charge during the first year of the contract will be $4.75 million per month. In subsequent years, the demand charge will be established by the Commission in SoCal's annual cost allocation proceeding (ACAP).

- Variable Charges. The Tier I rate during the first year will be $0.24 MMBtu, and the Tier II rate will be $0.15 MMBtu. The Tier I rate may be revised in conjunction with the 0.5 cent per therm discount from the 1989 ACAP average rate provided for in the contract. In subsequent years, both variable rates will be adjusted based on changes in SoCal's authorized margin.

- Minimum Charge. A minimum charge will be imposed quarterly based on the number of days in the quarter times ninety percent of the Tier I volumes times Tier I variable charge, plus the demand charge.

- Intrastate Priority. The priority for the Tier I volumes of 300 MMcfd in the summer and 200 MMcfd in the winter will be P-3. Tier II volumes will be P-5.

- Interstate Capacity. Firm interstate capacity is provided for Tier I volumes. Seventy percent of the volumes are on the El Paso system and thirty percent are on the Transwestern system.

- Storage. The contract provides 4 Bcf of storage, with SCE paying the in-kind injection charge and the operating and maintenance injection charge specified in the G-STOR tariff.

- Portfolio Switching Ban. The contract provides a waiver of the portfolio switching ban now in effect.

II. Issues

These contracts are the first under our new regulatory framework to be entered into by a gas utility and major customers for the provision of the full range of gas services. Those services include gas transportation, firm pipeline capacity, and storage. Two rates are included in the contract: one is a volumetric rate, the other is a flat demand charge. The rates are "bundled," that is, neither rate is associated with a specific service, such as storage or transportation.

The contracts also commit SDG&E and SCE to a revenue requirement by providing for minimum charges and take-or-pay volumes. These contract elements appear to be the quid pro quo for significant discounts from tariffed rates and guaranteed storage and pipeline capacity.

The contracts result in significant revenue shortfalls (losses) to SoCal, at least in the short term. SoCal proposes to recover these lost revenues from its other customers.

In general, the utilities--SoCal, SCE, and SDG&E--assert that the contracts benefit SoCal ratepayers over the contract term by reducing the risk of bypass or fuel switching by SCE and SDG&E. The utilities also believe the contracts benefit the customers of SCE and SDG&E by providing reduced rates and security of supply. The utilities believe the Commission should consider the contracts in light of the utility obligations of SDG&E and SCE.

Parties opposing the contracts believe that the contracts disadvantage competitors for pipeline and storage capacity, that they are unnecessarily costly and risky to SoCal ratepayers, and that they conflict with Public Utilities (PU) Code sections which address gas rates and service to cogenerators.

To determine whether the contracts are reasonable we need to determine the costs and benefits of the contracts, and balance those costs against the benefits. Specific issues are addressed in this decision:

1. Is approval of the contracts consistent with Commission policy regarding long-term contracts?

2. Do the contracts benefit SCE and SDG&E ratepayers?

3. Are the contracts consistent with PU Code § 739.6 regarding cost allocations?

4. Do the contracts provide an unreasonable advantage to SCE and SDG&E over other noncore customers?

5. Are the contracts fair and reasonable to SoCal ratepayers?

6. Are the contracts consistent with state law and Commission policy regarding cogenerators?

A. Is Approval of the Contracts Consistent with Commission Policy Regarding Long-term Contracts for Gas Services?

SoCal argues that the contracts are fully consistent with past Commission decisions and policies. It cites Decision (D.) 86-12-009, in which we found that long-term contracts would permit the utilities to negotiate service packages tailored to the needs of individual customers and thereby reduce utility and ratepayer risk. The primary objective of long-term contracts would be to reduce the risk of fuel switching and bypass by customers who might otherwise provide margin contributions.

DRA and TURN do not believe the contracts are consistent with current Commission policy which has evolved since the issuance of D.86-12-009. Specifically, DRA argues that D.86-12-009 is outdated because the gas utilities no longer have excess capacity and the Commission has issued several orders providing a regulatory framework for storage banking and interruptible capacity on interstate pipelines. The Commission anticipates development of market-based allocation for pipeline capacity, as set forth in D.88-12-009.

TURN also points out that the Commission's regulatory program has changed since D.86-12-009, in which the Commission expressed the desirability of long-term contracts. At that time, the Commission expected many, if not most, noncore customers would negotiate discounts because the default rate (i.e., the tariffed transportation rate) was high. Since that time, the Commission, in D.87-03-044, lowered noncore default rates to embedded costs. Accordingly, negotiated contracts are not the norm the Commission once expected they would be, and, TURN argues, the Commission should reconsider its view of long-term contracts.

Discussion. The purpose of discounted long-term contracts, as put forth in D.86-12-009, continues to be of primary importance to us. That purpose is "to encourage the utilities to attract incremental load which might otherwise be lost." We agree with TURN and DRA that circumstances have changed since the issuance of D.86-12-009. We have approved changes in rate design, developed a pilot storage banking program, and stated our intention to establish a capacity allocation program. These regulatory changes improve the position of noncore and wholesale customers, including SDG&E and SCE. They also reduce the impetus for bypass.

Notwithstanding the regulatory changes which have taken place since 1986, long-term contracts with discounted rates may still be a reasonable mechanism for preventing uneconomic bypass or fuel switching. We will therefore consider whether the contracts are necessary on that basis.

B. Do the Contracts Benefit SDG&E and SCE Ratepayers?

The utilities and the City of San Diego believe that the contracts provide significant benefits to ratepayers of SCE and SDG&E which should be considered. These benefits include lower rates, price stability, and supply security. According to SDG&E, the benefits to its ratepayers offset any costs to SoCal's ratepayers. SDG&E also comments that the contract allows it to become a major new buyer in the Southwest, which will enhance market competition and benefit all of California's ratepayers.

SCE believes it must reduce its reliance on the spot market and interruptible transportation because of an expected supply shortage. SCE states that the contract terms permit it to do that, with substantial benefits for its customers.

The parties did not challenge the utilities' assertions that the contracts would provide benefits to the ratepayers of SDG&E and SCE.

Discussion. Generally, it appears that SCE and SDG&E ratepayers benefit substantially from the contracts, at least during the first years, not only as a result of reduced prices but also because of increased supply security, and access to storage and pipeline capacity. The evidence offered in this proceeding does not permit a determination of whether the risks of the take-or-pay requirements in the contracts before us are offset by more stable gas supply services.

C. Are the Contracts Consistent with PU Code § 739.6 Regarding Cost Allocations?

SoCal believes that its proposal to allocate to its customers revenue shortfalls associated with the contracts is fully consistent with Public Utilities Code § 739.6 (enacted by SB 987). That section prohibits changes in cost allocation methodology until 1991 if those changes would harm residential customers. The contracts, according to SoCal, are designed to maximize long-run revenues from SDG&E and SCE and thereby protect residential ratepayers. SoCal also states that D.87-05-046 permitted allocation of contract shortfalls to other ratepayers. SoCal argues that the issue in this proceeding is not whether the Commission should approve any long-term service agreements, but whether the particular terms and conditions of these two service contracts should be approved.

SDG&E argues that § 739.6 is not violated by the contracts because the intent of SB 987 was primarily to protect low income customers from the effects of baseline rate design. Even if the Commission's interpretation of the bill is broader than this, SDG&E believes that long-term contracts were clearly part of the cost allocation methodology adopted by the Commission in D.86-12-009. In any event, the contract addresses an inequity between core customers by placing SDG&E customers on a more equal footing with those of SoCal. Section 739.6 allows the Commission to redress such inequities.

TURN believes that allocating revenue shortfalls to ratepayers would change the existing cost allocation methodology in violation of § 739.6. Revenue shortfalls, estimated to total about $31 million for both contracts, would be recovered from core ratepayers. TURN points out that, contrary to SoCal's assumption, D.87-05-046 permitted recovery of contract shortfalls only for those long-term contracts already in existence and were treated as "transition costs." Clearly, according to TURN, the Commission did not intend that future contracts would be similarly treated.

Nor, according to TURN, did the Commission in D.86-12-009 set forth specific treatment of long-term contracts which would have later been endorsed by § 739.6.

Discussion. D.86-12-009 anticipated that long-term contracts may be necessary to retain and increase load. That decision did not allocate specific contract costs to specific customers because no such contracts then existed. It did, however, assume that associated revenue shortfalls may need to be recovered from other customers. D.86-12-009 states that utility shareholders are liable, in reasonableness reviews, for revenue shortfalls from long-term contracts if the utility does not maximize contract revenue based on material information that was or should have been known at the time the long-term contract was signed. D.86-12-009 expressly prohibits reallocating revenue shortfalls associated with short-term contracts. As SoCal points out, these two statements together imply that we will consider allocating long-term contract revenue shortfalls to other customer groups. Therefore, we would not violate § 739.6 by allocating long-term contract shortfalls to other SoCal customers.

In addition, § 739.6 permits the Commission to change its cost allocation methodology under certain circumstances. Section 739.6 states that the Commission shall retain the cost allocation methodology adopted in D.86-12-009 and D.86-12-010 until December 31, 1990, except that:

> "the Commission may modify this cost allocation methodology to address customer hardships and inequities if residential customers as a class are not, on balance, adversely affected and the purpose of the modification is not solely protection of gas corporation revenues."

SoCal is correct that § 739.6 would not necessarily be violated simply because a long-term contract resulted in a revenue shortfall. In the context of the contracts which are before us, we interpret this section to permit us to reallocate costs to residential gas ratepayers if the contracts would protect them from significant rate increases which would otherwise occur due to uneconomic bypass or fuel switching.

We must therefore determine whether the contracts will prevent either a loss of significant contribution or address an inequity suffered by residential customers. We note that the allocation of any revenue shortfalls resulting from approval of the contracts would ultimately be determined in SoCal's ACAP.

We do not agree with SDG&E that § 739.6 is designed exclusively to protect low-income customers from the effects of baseline rate design. The language in that section clearly prohibits us from changing our cost allocation methodology, with very limited exceptions, until 1991. That section does not limit its application solely to those situations where baseline rates may affect low income customers.

D. Do the Contracts Provide an Unreasonable Advantage to SDG&E and SCE over other Noncore Customers?

Many parties, including DRA, TURN, CSC, CCC, Trigen, and CIG, believe the contracts compromise the Commission's efforts to adopt a comprehensive program for capacity allocation, although none objected to the use of long-term contracts in general. CSC and CIG point out that the Commission has repeatedly expressed its preference for a market-based priority charge, established by bidding. The contracts remove SoCal's largest gas loads from any market-driven program and thereby circumvent a Commission program.

DRA, Trigen, TURN, CIG, and CSC agree that the SoCal contracts provide unwarranted preferential arrangements for SDG&E and SCE which will prejudice other noncore customers seeking gas services. Trigen points out that the contracts offer two of SoCal's 800 noncore customers 20 to 25 percent of SoCal's total interstate pipeline capacity rights. SoCal's pending negotiations with other Southern California utilities would result in the allocation of almost 80 percent of SoCal's capacity prior to the development of a Commission program or an opportunity for other noncore customers to participate in the allocation process.

Similarly, according to CSC, the contracts circumvent the Commission's storage banking program by granting SDG&E and SCE long-term storage rights which are not available to other customers under the existing pilot program.

DRA also objects to the contracts because they appear to commit SoCal to construction of new capacity. DRA notes SoCal's testimony that, if a large number of noncore customer seek long-term contracts, new capacity may be required. DRA objects to contracts which commit SoCal to long-term capacity prior to the development of a capacity allocation program.

Finally, DRA believes other noncore customers will be harmed by the contracts because significant risk to SoCal is reduced, thereby providing SoCal with additional leverage in its negotiations with noncore customers who negotiate for services in the future.

SoCal does not believe the contracts provide an unfair advantage to SCE and SDG&E over other noncore customers. Other noncore customers may negotiate similar contracts for packages of gas services at a later time. SoCal chose to negotiate first with SCE and SDG&E because they are its two largest noncore customers and because both are utilities with public service obligations.

SCE asserts that approval of the contracts will not prejudice the outcome of the capacity allocation proceedings, and the Commission's decision to review the contracts in advance of hearings in R.88-08-018 is appropriate.

SDG&E argues that its contract with SoCal reflects its unique position as a local distribution company with special responsibility to serve its customers, a responsibility which retail customers do not have. It cites D.86-12-009, in which we found that "(w)holesale customers are unique because their customer class has both core and non-core elements, and due to the fact that they impose fewer costs on the primary utility than do retail customers." The contract with SoCal allows SDG&E to fulfill its utility responsibility by eliminating the inferior quality of service provided SDG&E compared with SoCal and Pacific Gas and Electric Company (PG&E). SCE makes similar points regarding its obligations as a public utility.

Discussion: Although approval of the contracts may favor two SoCal noncore customers over others, the contracts may be reasonable if SDG&E and SCE have a utility obligation which distinguishes them from other noncore customers and competitors. Clearly, both SDG&E and SCE have such a utility obligation. With respect to SDG&E, it has long been the wish of this Commission to see an agreement with SoCal that would afford SDG&E access to firm capacity and storage service in order to allow SDG&E to meet its own independent utility obligations, especially to the core.

Despite the Commission's intentions with respect to long-term contracts for SCE and SDG&E, we are concerned that our approval of the contracts before us could prejudge the implementation of our capacity allocation program. While we conclude that these contracts do not provide an unreasonable advantage to SCE and SDG&E over other noncore customers, we will require certain changes to promote equal access to long term capacity assignment rights.

Specifically, we will require that all of the firm capacity allocated under these contracts be subject to recall by subsequent decision of the Commission. This provision will enable the Commission to ensure that long term contracts do not tie up all the available firm capacity rights so as to preclude an effective; non-discriminatory capacity brokering program, which we are proceeding to develop in R.88-08-018.

We have similar concerns about the impact of these contracts on our permanent storage program, which we intend to develop in place of the current pilot program. We will require that the contracts provide for termination, upon Commission order, of SCE's and SDG&E's rights to inject gas.

E. Are the Contracts Fair and Reasonable to SoCal Ratepayers?

We next need to consider whether the contracts are fair to SoCal ratepayers, and whether those contracts are needed to prevent uneconomic bypass or fuel-switching.

SoCal estimates a revenue shortfall from the contracts of about $23.2 million for the SDG&E contract and about $8.1 million for the SCE contract. DRA estimates the shortfall to be about $7.4 million for the SDG&E contract and $6.0 million for the SCE contract. DRA's estimate differs from SoCal's because of differing assumptions regarding revenue requirement.

SoCal believes the rates in the contracts are reasonable. Except in the first year, SCE's demand charge will be established by the Commission in SoCal's ACAPs. SDG&E's analysis of the difference between revenues at SDG&E's contract rate and at default rates over the next five years shows that SDG&E's discount will only be a few percent below default revenues, especially in 1991 and after.

SoCal argues that rate discounts are necessary because SCE and SDG&E have viable alternatives to SoCal's gas services, among them, service to SCE by the City of Long Beach, the construction of a pipeline by SCUPP, and the construction of a pipeline from the Colorado River by SDG&E. The take-or-pay obligations further assure that fuel-switching or bypass will not become an economic alternative for either SDG&E or SCE.

CIG objects to the reallocation of these costs to other ratepayers and believes the contracts eliminate risk to SoCal, risk which the Commission has determined is appropriate. Under current Commission policy, according to CIG, SoCal is at risk for revenue shortfalls resulting from discounts to the default rate which occur between ACAPs. CIG states SoCal has not offered such discounts to SCE or SDG&E prior to this time. The contracts, however, provide significant discounts to the default rate and add service improvements by way of firm interstate capacity, improved priority, storage capacity, most favored nation clauses, and a waiver of the portfolio switching ban. CIG believes that because the contracts have terms of five years or more, SoCal seeks to escape responsibility for these discounts by shifting the risk to other customers. CIG asserts that SoCal's interpretation of D.86-12-009, that SoCal is insulated from the negative effects of a negotiated discount because the discount is part of a long-term contract, is fundamentally inconsistent with the Commission's adopted regulatory structure.

CIG believes that SoCal should not be shielded from risk under long-term contracts, just as it is not shielded from risk during the short-term for rate discounts to large customers. CIG believes exceptions to this rule may be reasonable if, for example, long-term discounts were required to maintain or expand load. In this case, CIG believes SoCal has not demonstrated risk of bypass or fuel-switching. In light of this, and because SoCal has not needed to discount the default rate previously, CIG argues the passthrough of the revenue shortfall to other customers cannot be justified.

TURN shares the concern that if SoCal is able to pass along the revenue shortfall from discounting, it will have no incentive to minimize the discounts. On the other hand, SoCal has shielded shareholder risk by trading off the discounts absorbed by ratepayers for a 90 percent transport-or-pay condition. TURN suggests the Commission direct SoCal to enter into long-term core transmission service agreements with its wholesale customers for their core loads in recognition of the need for stable core gas supplies.

DRA makes similar arguments and believes the contracts violate Commission orders prohibiting core election when the core portfolio is priced lower than the noncore portfolio. The prohibition was established to preclude a situation where increased gas purchases to serve a larger core group increase the core portfolio rate.

DRA also believes that SDG&E entered into the contracts as a way to circumvent the Commission's decisions in SoCal's ACAP. It notes SDG&E testimony stating that the cost allocation methodology applied to SDG&E in the SoCal ACAP resulted in costs which were higher than SDG&E felt they should have been.

Discussion. The contracts provide to SoCal significant revenue stability associated with the take-or-pay provisions and demand charges. For these commitments, SDG&E and SCE are assured access to firm interstate capacity, improved access to storage banking and discounts from default tariffs. The utilities state the contracts benefit SoCal ratepayers by mitigating against bypass, by providing revenue stability, and by committing SDG&E and SCE to pay their fair share of transition costs.

A threshold question in this proceeding is whether the contract terms are needed to avert uneconomic bypass. If they are, SoCal's ratepayers may benefit from the contracts by retaining some contribution to rates.

Neither SoCal, SCE, nor SDG&E have provided any convincing analysis to support the claim that the contracts are needed to prevent uneconomic bypass or fuel-switching. Pipeline construction may be an option, but the record does not demonstrate whether it is an economic option for SCE or SDG&E. SoCal testified that SCE burned fuel oil last winter, but we have no information regarding the circumstances which made fuel-switching economic. Although SoCal's witness testified that he had undertaken a bypass study, the study was not presented on the record, and we are therefore unsure whether its methods and conclusions are reasonable.

While the Commission is concerned about the potential for uneconomic bypass and seeks to avoid it where possible, we will not approve discounted rates and the resulting cost shift to other ratepayer classes without a strong showing. In this case, it is clear that no conclusive demonstration of the bypass threat for SCE and SDG&E exists. While a number of options may be available to the utilities, the efficiency of these alternatives has not been demonstrated sufficiently to allow us to approve discounted rates for SCE and SDG&E.

Thus, in this particular case we are not convinced that the discounts SoCal negotiated with SDG&E and SCE are in fact reasonable. Essentially, SCE and SDG&E are receiving a premium service (improved access to storage and firm capacity) at a discounted rate.

We are not, however, willing to reject the premium service components of the contract. The contracts, without the discounts, represent reasonable long-term capacity assignment and storage banking services for two important customers with their own utility obligations. Our primary concerns with the service elements of these long-term contracts--that they might adversely affect our final capacity brokering program--have been addressed by the recall conditions we will place on approval of the contracts. (Section II.D above.)

In regard to the waiver of the portfolio switching ban for SDG&E and SCE, we have seen no legitimate justification for this waiver. We thus reject this portion of the contracts.

F. Are the Contracts Consistent with State Law and Commission Policy Regarding Cogeneration Rates?

SoCal asserts that the contracts are consistent with the Commission's policies toward cogenerators because SoCal is willing to negotiate special agreements with cogeneration customers under similar terms and conditions as Edison has obtained. SoCal notes that four cogeneration customers have already signed long-term contracts with SoCal. SDG&E makes similar points.

SCE goes further by asserting that cogenerators are not satisfied with rate parity, which SoCal is willing to offer by negotiating similar terms and conditions for similarly situated cogeneration customers. Cogenerators, according to SCE, want additional subsidies. SCE believes the Commission's existing policy goes beyond the requirements of § 454.4 by basing cogenerator rates on the average UEG rate with higher priority than UEG customers. SCE comments that the contract's provision increasing its priority to P-3 will not reduce service levels to other customers because SoCal expects no curtailments for P-1 through P-4 customers during the contract period.

The cogeneration customers object to the contracts on the grounds that they violate §§ 454.4 and 454.7 of the PU Code, which provide generally that cogenerators shall have the highest possible priority for the purchase of natural gas at rates not higher than the established UEG rate. These provisions were enacted in recognition of the efficiencies of cogeneration facilities and the associated benefits to all Californians.

According to CSC and CCC, the contracts violate these provisions by significantly increasing SCE's P-3 volumes. They are also violated, according to CSC, because the contracts' bundled rates for a range of services are below the current transportation-only rate. CSC contends that SoCal's offer to negotiate similar contracts with customers who are similarly-situated violates the Commission's policy that cogenerators are to be treated equally and that they are to receive rates no higher than UEG rates, notwithstanding their situation. CSC points out that SoCal's witness could identify only one cogeneration customer who might qualify for a package similar to SCE's.

Similarly, CCC argues that SoCal's offer to negotiate contracts with cogenerators is unacceptable. SoCal testified that it would not consider offering rates or service similar to those in the proposed contracts unless cogenerators demonstrated the same "market conditions" faced by SCE and SDG&E. CCC believes cogeneration customers cannot demonstrate such market conditions and could therefore not realize rate parity with UEGs as required by law.

CCC and CSC believe that if the Commission approves the contracts, it must also require that SoCal offer the same rates and services to cogenerators as are offered to UEGs under the contracts. These concessions must be made, under §§ 454.4 and 454.7, regardless of whether cogenerators enter into contracts with SoCal and regardless of whether they are identically situated to SCE and SDG&E. All rates should be unbundled. SoCal should also be required to curtail UEG customers ahead of cogenerators.

Trigen proposes the Commission defer contract approval until other noncore customers and marketers are given the opportunity to enter into similar contracts.

Finally, CSC argues that SoCal cannot, as it proposes, fail to include the Edison contract rate in determining the average UEG rate used to calculate the rate to cogenerators. Such failure would be a clear violation of § 454.4.

Discussion. With regard to the effect of these contracts on cogenerators there are two issues: rate parity and priority. With respect to rate parity, the elimination of the discounts given to SCE and SDG&E obviates the need to address this issue.

With regard to cogenerator priority, section 454.7 states:

> "The Commission shall, to the extent permitted by federal law and consistent with Section 2771, provide cogeneration technology projects with the highest possible priority for the purchase of natural gas."

Section 2771 allows the Commission to establish service priorities based on its determination of which customers and uses "provide the most important public benefits and serve the greatest public need."

It is clear that the SoCal contracts intend to provide for a priority level at least equal to the priority level established for cogenerators for about 90 percent of SDG&E's load and about half of SCE's load. Although SoCal's witness testified that SoCal does not expect curtailments above P-5 during the contract period, it offered no specific analysis or evidence to support that claim. In fact, that view appears inconsistent with SoCal's testimony that both pipeline capacity and natural gas may be in shorter supply in the future, especially since the contracts would add significant additional volumes to the P-3 category. Moreover, we wonder why the UEGs must be assigned a priority level higher than cogenerators if SoCal does not expect to curtail any customers above the P-5 level.

We could permit higher priority for UEGs under § 2771, but we would first need to find that the UEGs provide more important public benefits than cogenerators. We see no compelling reason to do so at this time. Without such a finding, the contracts as written are inconsistent with § 454.7.

We do not reject the upgrade of priority for the stated volumes to P-3. However, cogenerators must receive a higher priority than UEG customers within their respective service territories. The contracts should be modified accordingly.

III. Conclusions

We have highlighted several concerns regarding the contracts as filed and made several observations about long-term contracts more generally. We affirm our view that long-term contracts are appropriate under certain circumstances. They are primarily useful where a customer must make a decision regarding whether or not to invest in bypass facilities and such facilities would clearly result in uneconomic bypass.

In this proceeding, we are not convinced that SCE or SDG&E will undertake uneconomic bypass absent the contracts. Unless SoCal can clearly demonstrate the necessity of a long-term contract to avoid uneconomic bypass, we will not allocate to other SoCal ratepayers revenue shortfalls associated with those contracts. Without such proof, and in the absence of some type of risk-sharing mechanism, we believe that SoCal may be inclined to sign long-term contracts with all of its major customers. This circumstance would turn our new regulatory program--which was designed to promote competition and more efficient utility management--on its head.

We are also concerned about the effect these long term contracts may have on our final pipeline capacity brokering program. We are committed to the development of a non-discriminatory and open process for the allocation of pipeline capacity, a process which is now under consideration in R.88-08-018. We are also aware that the contracts under consideration in this proceeding will affect the development and approval by the FERC of an interstate pipeline allocation program.

On the other hand, both SDG&E and SCE have public utility obligations, especially to their core customers. The availability to them of firm storage and pipeline capacity would improve their ability to negotiate long term purchases of natural gas, thereby improving the reliability of their respective systems. Firm capacity will also give SDG&E and SCE more negotiating leverage for short term gas purchases, potentially resulting in lower priced gas for their ratepayers and a more competitive procurement market.

We see no harm in approving certain elements of the contracts if their approval is on an interim basis and subject to any conditions which may be imposed by the FERC and our determinations in our capacity brokering proceeding. We would therefore be disposed to approve contracts with the safeguards described in this order.

To address the our concerns regarding SoCal's ratepayers and cogeneration customers, the modified contracts should offer no discounts from tariffed rates.

The contracts should also be modified so that all firm pipeline capacity is made subject to recall by the Commission, effective on or after November 1, 1990. Similarly, the right to inject gas into storage should be terminable by the Commission, effective on or after November 1, 1990. The recall provision would assure that the contracts do not prejudice our capacity allocation and storage banking proceedings but would give the parties some opportunity over the next year to gain experience with a capacity assignment arrangement, on an interim basis. This provision would also give the utilities increased system reliability during the summer and fall when air quality concerns are most serious. The Commission will give suitable notice to SoCal, SCE and SDG&E of the recall action in a formal Commission order. The order may be issued before November 1, depending primarily on our progress in R.88-08-018, but the recall provision would in any event not take effect before November 1, 1990.

The modified contracts should also provide that priority for cogenerators will continue to be higher than that for UEG customers consistent with the requirements of the Code. Finally, the waiver of the portfolio switching ban should be eliminated from the contracts.

One unaddressed issue concerns the level of take-or-pay obligations that SCE and SDG&E would incur with contract modifications eliminating the rate discounts and adding the recall provision for firm capacity and storage injection. The contracts currently have provisions for a 90% take-or-pay obligation on the part of SCE and SDG&E. We expect this obligation to be reduced somewhat to account for the modifications that are required in the resubmitted contracts, although the 70% obligation suggested by Edison in its comments appears to be too low. We remark, however, that the parties should not in their negotiations underestimate the value of firm capacity with or without a discount.

If these conditions are acceptable to SoCal, SDG&E and SCE, SoCal should file amended contracts that conform to today's decision, by advice letter within 60 days.

<u>Findings of Fact</u>

1. SoCal has applied for approval of long-term gas service contracts with SDG&E and SCE. The contracts provide discounted rates for a full range of natural gas services, including storage, transportation, and firm pipeline capacity.

2. D.86-12-009 stated that the utilities may negotiate long-term contracts to encourage the utilities to attract incremental load which might otherwise be lost.

3. Since the issuance of D.86-12-009, the Commission has reduced default transportation rates, developed a pilot storage banking program, and stated its intention to establish a pipeline capacity allocation program, all of which tend to reduce the risk of uneconomic bypass of the gas utilities' systems.

4. No party to this proceeding argued that the contracts would harm the ratepayers of SCE or SDG&E.

5. D.86-12-009 stated that utility shareholders may be liable in reasonableness reviews for revenue shortfalls from long-term contracts if the utility does not maximize contract revenue based on material information that was or should have been known at the time the long-term contract was signed. That decision expressly prohibits reallocating revenue shortfalls associated with short-term contracts.

6. Other noncore customers have not had an opportunity to negotiate contracts or bid for the range of services the contracts provide SCE and SDG&E.

7. SCE and SDG&E have utility obligations which other, non-UEG customers do not have.

8. The record does not demonstrate that the contracts are required in order to prevent uneconomic bypass or fuel-switching.

9. The contract terms which permit portfolio switching are contrary to the rule which prohibits portfolio switching and which applies to all other noncore customers.

10. The contracts provide for service priority for significant volumes of UEG gas which is higher than the priority for cogenerators.

11. Long-term contracts may be required to prevent uneconomic bypass or fuel switching.

<u>Conclusions of Law</u>

1. Nothing in this decision should be construed as a finding of reasonableness regarding SCE or SDG&E's decisions to sign the subject contracts with SoCal.

2. D.86-12-009 assumed that revenue shortfalls from long-term contracts may be allocated to ratepayers in appropriate circumstances.

3. P.U. Code Section 739.6 would not be violated if the Commission reallocated revenue shortfalls resulting from a long-term contract to SoCal ratepayers if the contract was required to prevent harm to ratepayers resulting from significant revenue losses associated with uneconomic bypass, because such reallocation was intended by D.86-12-009.

4. P.U. Code Section 454.4 requires that cogenerators are offered rates no higher than those offered by a gas utility to UEG customers in the gas utility's service territory.

5. P.U. Code Section 454.7 requires that cogenerators receive the highest possible priority for the purchase of natural gas.

6. The waiver of the portfolio switching ban is inconsistent with current Commission policy and is thus unreasonable.

7. The discounts offered in the contracts are not reasonable.

8. The Commission should deny SoCal's request for approval of its long-term contracts with SCE and SDG&E.

9. The Commission should consider approving a renegotiated contract between SDG&E and SoCal which (1) does not offer discounts, (2) provides that all pipeline and storage capacity will

be subject to recall by the Commission on or after November 1, 1990, (3) provides for the curtailment of contract volumes before cogenerator volumes, and (4) does not waive the portfolio switching ban. The utilities may also renegotiate the take-or-pay provisions of the contract to reflect contract modifications set forth in this decision.

10. The Commission should consider approving a renegotiated contract between SCE and SoCal which (1) does not offer discounts, (2) provides that all pipeline and storage capacity will be subject to recall by the Commission on or after November 1, 1990, (3) provides for the curtailment of contract volumes before cogenerator volumes, and (4) does not waive the portfolio switching ban. The utilities may also renegotiate the take-or-pay provisions of the contract to reflect contract modifications set forth in this decision.

11. If the parties renegotiate their contracts pursuant to Conclusions of Law 10 and 11, SoCal shall file advice letters seeking approval of the amended contracts. The advice letter(s) should be filed within 60 days of the effective date of this order and should be served on all parties to this proceeding.

12. This order shall be made effective immediately so that renegotiation between SoCal, SCE, and SDG&E may take place as soon as possible.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company's (SoCal) request for approval of its contract with Southern California Edison Company (SCE) is denied.

2. Southern California Gas Company's (SoCal) request for approval of its contract with San Diego Gas and Electric (SDG&E) is denied.

3. SoCal may, within 60 days of the date of this order, file for approval of an advice letter which would establish the terms and conditions of a contract with SCE, amended in conformance with this decision. The advice letter shall be served on all parties to this proceeding.

4. SoCal may, within 60 days of the effective date of this order, file for approval of an advice letter which would establish the terms and conditions of a contract with SDG&E, amended in conformance with this decision. The advice letter shall be served on all parties to this proceeding.

This order is effective today.

Dated DEC 1 8 1989, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Wesley Franklin

WESLEY FRANKLIN, Acting Executive Director

pB

H-1a

State of California

Public Utilities Commission
San Francisco

M E M O R A N D U M

Date : December 1, 1989

To : The Commission
(Meeting of December 6, 1989)

From : Commissioner Hulett SWH

File No.:

Subject : Alternate for H-1, SoCal long-term contracts with SCE and SDG&E

This is an alternate decision for ALJ Malcolm's decision on the SoCal long-term contracts for transportation and other services with SCE and SDG&E.

This decision will still reject the contracts but will outline the modifications we believe would make the contracts acceptable. These modifications are:

1. The elimination of the discounts for transportation service specified in the contracts;

2. Allowing a certain percentage of the firm capacity allocated under the contracts to be "recallable" by the Commission for the purposes of the capacity brokering program being considered in OIR 88-08-018. The portion of the capacity to be recallable is to be negotiated by the utilities;

3. Ensuring that cogenerators have a higher priority than UEG customers;

4. Renegotiation of the take-or-pay levels to something less than the 90% level of the contracts;

5. Elimination of the waiver of the portfolio switching ban.

There are changes to most sections but predominately Section D and beyond, starting on page 11.

COM/SWH/cgm

Decision ________________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company to implement a firm capacity allocation contract with San Diego Gas & Electric Company by Advice Letter 1864, filed March 20, 1989.	(I&S) Case 89-05-016 (Filed May 10, 1989)
In the Matter of the Application of Southern California Gas Company to implement a firm capacity allocation contract with Southern California Edison Company by Advice Letter 1872, filed May 2, 1989.	
And Related Matters.	R.88-08-018 (Filed December 21, 1988) I.87-03-036 (Filed March 25, 1987)

(Appearances are listed in Appendix A.)

OPINION

This decision addresses Southern California Gas Company's (SoCal) request for approval of two contracts, one with San Diego Gas & Electric Company (SDG&E) and one with Southern California Edison Company (SCE). Both contracts are for a range of gas services from SoCal.

SoCal originally applied for contract approval by filing advice letters. On May 10, 1989, we issued an order instituting an investigation and suspension of Advice Letter 1864 and Advice Letter 1872 which requested approval of the contracts. We initiated this investigation because of the many protests to the advice letters we received. Generally, the protests commented that the contracts prejudiced our resolution of issues in R.88-08-018 and raised equity issues.

Eight days of hearings were held in this proceeding. The case was submitted on August 23, 1989. The parties supporting the contracts were SoCal, SCE, SDG&E, and the City of San Diego. The parties opposing the contracts included the Division of Ratepayer Advocates (DRA), Toward Utility Rate Normalization (TURN), California Cogeneration Council (CCC), California Industrial Group and the California League of Food Processors (CIG), Cogenerators of Southern California (CSC), and Trigen Resources Corporation (Trigen).

This decision rejects these contracts as filed, but offers conditions upon which we would approve them. A number of provisions of the agreements SoCal negotiated violate previously articulated Commission policies or are inconsistent with sections of the Public Utility Code and, thus, the contracts require some modifications. This decision provides guidance to the gas utilities regarding modifications to these agreements and also general guidance on long-term contracts for which they may seek approval in the future.

I. The Contracts

A. Contract with SDG&E

SoCal's contract with SDG&E provides for all of SDG&E's gas service needs, including long-term price and service commitments for transportation and storage of SDG&E-owned gas, gas sales to SDG&E by SoCal, and firm interstate capacity rights. The initial term is five years. At the end of the second contract year and each anniversary thereafter, the contract would be automatically extended for an additional one-year period unless either party notifies the other of contract cancellation.

Specific elements of the contract include:

- Demand Charges. The demand charge during the first year of the contract will be \$5.4 million per month. In subsequent years, the demand charge will be adjusted based on the percent change in SoCal's total non-gas costs as authorized by the Commission.

- Transmission Charges. The transmission volumetric rate during the first year will be \$0.10 per million British thermal units (MM/Btu). In subsequent years, the transmission rate will escalate in the same manner as the demand charge.

- Minimum Charge. A minimum charge will be imposed quarterly based on the number of days in the quarter times 270 million cubic feet per day (MMcfd) times the transmission charge, plus the demand charge. This equates to a ninety percent "take-or-pay" on the transmission charge.

- Intrastate Priority. The priority for UEG volumes up to 125 MMcfd will be P-3.

- Interstate Capacity. Firm interstate capacity is provided for up to 300 MMcfd (225 MMcfd on El Paso and 75 MMcfd on Transwestern). This provision is subject to FERC approval of a compatible capacity program. Prior to this approval, a "buy/resale" arrangement will be implemented.

- Storage. The contract provides 12.7 billion cubic feet (Bcf) of storage. Additional storage volumes are available at the prices contained in the G-STOR tariff except for the reservation fee.

- Portfolio Switching Ban. The contract provides a waiver of the portfolio switching ban now in effect.

B. Contract with SCE

The contract with SCE provides all of SCE's gas service needs, including long-term pricing and service commitments for transportation, storage, and distribution of SCE-owned gas, retail gas sales to SCE by SoCal, and firm interstate capacity rights. The initial term is five years. At the end of the fourth contract year and each anniversary year thereafter, the contract is automatically extended for an additional one-year period unless either party notifies the other of contract cancellation.

Specific provisions of the contract include:

- Demand Charges. The demand charge during the first year of the contract will be $4.75 million per month. In subsequent years, the demand charge will be established by the Commission in SoCal's annual cost allocation proceeding (ACAP).

- Variable Charges. The Tier I rate during the first year will be $0.24 MMBtu, and the Tier II rate will be $0.15 MMBtu. The Tier I rate may be revised in conjunction with the 0.5 cent per therm discount from the 1989 ACAP average rate provided for in the contract. In subsequent years, both variable rates will be adjusted based on changes in SoCal's authorized margin.

- Minimum Charge. A minimum charge will be imposed quarterly based on the number of days in the quarter times ninety percent of the Tier I volumes times Tier I variable charge, plus the demand charge.

- Intrastate Priority. The priority for the Tier I volumes of 300 MMcfd in the summer and 200 MMcfd in the winter will be P-3. Tier II volumes will be P-5.

- Interstate Capacity. Firm interstate capacity is provided for Tier I volumes. Seventy percent of the volumes are on the El Paso system and thirty percent are on the Transwestern system.

- Storage. The contract provides 4 Bcf of storage, with SCE paying the in-kind injection charge and the operating and maintenance injection charge specified in the G-STOR tariff.

- <u>Portfolio Switching Ban</u>. The contract provides a waiver of the portfolio switching ban now in effect.

II. <u>Issues</u>

These contracts are the first under our new regulatory framework to be entered into by a gas utility and major customers for the provision of the full range of gas services. Those services include gas transportation, firm pipeline capacity, and storage. Two rates are included in the contract: one is a volumetric rate, the other is a flat demand charge. The rates are "bundled," that is, neither rate is associated with a specific service, such as storage or transportation.

The contracts also commit SDG&E and SCE to a revenue requirement by providing for minimum charges and take-or-pay volumes. These contract elements appear to be the quid pro quo for significant discounts from tariffed rates and guaranteed storage and pipeline capacity.

The contracts result in significant revenue shortfalls (losses) to SoCal, at least in the short term. SoCal proposes to recover these lost revenues from its other customers.

In general, the utilities--SoCal, SCE, and SDG&E--assert that the contracts benefit SoCal ratepayers over the contract term by reducing the risk of bypass or fuel switching by SCE and SDG&E. The utilities also believe the contracts benefit the customers of SCE and SDG&E by providing reduced rates and security of supply. The utilities believe the Commission should consider the contracts in light of the utility obligations of SDG&E and SCE.

Parties opposing the contracts believe that the contracts disadvantage competitors for pipeline and storage capacity, that they are unnecessarily costly and risky to SoCal ratepayers, and that they conflict with Public Utilities (PU) Code sections which address gas rates and service to cogenerators.

To determine whether the contracts are reasonable we need to determine the costs and benefits of the contracts, and balance those costs against the benefits. Specific issues are addressed in this decision:

1. Is approval of the contracts consistent with Commission policy regarding long-term contracts?

2. Do the contracts benefit SCE and SDG&E ratepayers?

3. Are the contracts consistent with PU Code § 739.6 regarding cost allocations?

4. Do the contracts provide an unreasonable advantage to SCE and SDG&E over other noncore customers?

5. Are the contracts fair and reasonable to SoCal ratepayers?

6. Are the contracts consistent with state law and Commission policy regarding cogenerators?

A. Is Approval of the Contracts Consistent with Commission Policy Regarding Long-term Contracts for Gas Services?

SoCal argues that the contracts are fully consistent with past Commission decisions and policies. It cites Decision (D.) 86-12-009, in which we found that long-term contracts would permit the utilities to negotiate service packages tailored to the needs of individual customers and thereby reduce utility and ratepayer risk. The primary objective of long-term contracts would be to reduce the risk of fuel switching and bypass by customers who might otherwise provide margin contributions.

DRA and TURN do not believe the contracts are consistent with current Commission policy which has evolved since the issuance of D.86-12-009. Specifically, DRA argues that D.86-12-009 is outdated because the gas utilities no longer have excess capacity and the Commission has issued several orders providing a regulatory framework for storage banking and interruptible capacity on interstate pipelines. The Commission anticipates development of market-based allocation for pipeline capacity, as set forth in D.88-12-009.

TURN also points out that the Commission's regulatory program has changed since D.86-12-009, in which the Commission expressed the desirability of long-term contracts. At that time, the Commission expected many, if not most, noncore customers would negotiate discounts because the default rate (i.e., the tariffed transportation rate) was high. Since that time, the Commission, in D.87-03-044, lowered noncore default rates to embedded costs. Accordingly, negotiated contracts are not the norm the Commission once expected they would be, and, TURN argues, the Commission should reconsider its view of long-term contracts.

Discussion. The purpose of discounted long-term contracts, as put forth in D.86-12-009, continues to be of primary importance to us. That purpose is "to encourage the utilities to attract incremental load which might otherwise be lost." We agree with TURN and DRA that circumstances have changed since the issuance of D.86-12-009. We have approved changes in rate design, developed a pilot storage banking program, and stated our intention to establish a capacity allocation program. These regulatory changes improve the position of noncore and wholesale customers, including SDG&E and SCE. They also reduce the impetus for bypass.

Notwithstanding the regulatory changes which have taken place since 1986, long-term contracts with discounted rates may still be a reasonable mechanism for preventing uneconomic bypass or fuel switching. We will therefore consider whether the contracts are necessary on that basis.

B. Do the Contracts Benefit
<u>SDG&E and SCE Ratepayers</u>?

The utilities and the City of San Diego believe that the contracts provide significant benefits to ratepayers of SCE and SDG&E which should be considered. These benefits include lower rates, price stability, and supply security. According to SDG&E, the benefits to its ratepayers offset any costs to SoCal's ratepayers. SDG&E also comments that the contract allows it to become a major new buyer in the Southwest, which will enhance market competition and benefit all of California's ratepayers.

SCE believes it must reduce its reliance on the spot market and interruptible transportation because of an expected supply shortage. SCE states that the contract terms permit it to do that, with substantial benefits for its customers.

The parties did not challenge the utilities' assertions that the contracts would provide benefits to the ratepayers of SDG&E and SCE.

Discussion. Generally, it appears that SCE and SDG&E ratepayers benefit substantially from the contracts, at least during the first years, mainly as a result of reduced prices, increased supply security, and access to storage and pipeline capacity. The evidence offered in this proceeding does not permit a determination of whether the risks of the take-or-pay requirements in the contracts before us are offset by more stable gas supply services.

C. Are the Contracts Consistent with PU Code
<u>§ 739.6 Regarding Cost Allocations?</u>

SoCal believes that its proposal to allocate to its customers revenue shortfalls associated with the contracts is fully consistent with Public Utilities Code § 739.6 (enacted by SB 987). That section prohibits changes in cost allocation methodology until 1991 if those changes would harm residential customers. The contracts, according to SoCal, are designed to maximize long-run revenues from SDG&E and SCE and thereby protect residential ratepayers. SoCal also states that D.87-05-046 permitted allocation of contract shortfalls to other ratepayers. SoCal argues that the issue in this proceeding is not whether the Commission should approve any long-term service agreements, but whether the particular terms and conditions of these two service contracts should be approved.

SDG&E argues that § 739.6 is not violated by the contracts because the intent of SB 987 was primarily to protect low income customers from the effects of baseline rate design. Even if the Commission's interpretation of the bill is broader than this, SDG&E believes that long-term contracts were clearly part of the cost allocation methodology adopted by the Commission in D.86-12-009. In any event, the contract addresses an inequity between core customers by placing SDG&E customers on a more equal footing with those of SoCal. Section 739.6 allows the Commission to redress such inequities.

TURN believes that allocating revenue shortfalls to ratepayers would change the existing cost allocation methodology in violation of § 739.6. Revenue shortfalls, estimated to total about $31 million for both contracts, would be recovered from core ratepayers. TURN points out that, contrary to SoCal's assumption, D.87-05-046 permitted recovery of contract shortfalls only for those long-term contracts already in existence and were treated as "transition costs." Clearly, according to TURN, the Commission did not intend that future contracts would be similarly treated.

Nor, according to TURN, did the Commission in D.86-12-009 set forth specific treatment of long-term contracts which would have later been endorsed by § 739.6.

Discussion. D.86-12-009 anticipated that long-term contracts may be necessary to retain and increase load. That decision did not allocate specific contract costs to specific customers because no such contracts then existed. It did, however, assume that associated revenue shortfalls may need to be recovered from other customers. D.86-12-009 states that utility shareholders are liable, in reasonableness reviews, for revenue shortfalls from long-term contracts if the utility does not maximize contract revenue based on material information that was or should have been known at the time the long-term contract was signed. D.86-12-009 expressly prohibits reallocating revenue shortfalls associated with short-term contracts. As SoCal points out, these two statements together imply that we will consider allocating long-term contract revenue shortfalls to other customer groups. Therefore, we would not violate § 739.6 by allocating long-term contract shortfalls to other SoCal customers.

In addition, § 739.6 permits the Commission to change its cost allocation methodology under certain circumstances. Section 739.6 states that the Commission shall retain the cost allocation methodology adopted in D.86-12-009 and D.86-12-010 until December 31, 1990, except that:

> "the Commission may modify this cost allocation methodology to address customer hardships and inequities if residential customers as a class are not, on balance, adversely affected and the purpose of the modification is not solely protection of gas corporation revenues."

SoCal is correct that § 739.6 would not necessarily be violated simply because a long-term contract resulted in a revenue shortfall. In the context of the contracts which are before us, we interpret this section to permit us to reallocate costs to residential gas ratepayers if the contracts would protect them from significant rate increases which would otherwise occur due to uneconomic bypass or fuel switching.

We also agree with SDG&E that § 739.6 would permit us to reallocate revenues from the residential gas customers of SDG&E to those of SoCal if SDG&E's residential gas customers are suffering an inequity under existing circumstances. We do not believe that the Legislature intended to restrict us from redressing inequities which may exist between the residential gas customers of two regulated utilities.

We must therefore determine whether the contracts will prevent either a loss of significant contribution or address an inequity suffered by residential customers. We note that the allocation of any revenue shortfalls resulting from approval of the contracts would ultimately be determined in SoCal's ACAP.

We do not agree with SDG&E that § 739.6 is designed exclusively to protect low-income customers from the effects of baseline rate design. The language in that section clearly prohibits us from changing our cost allocation methodology, with very limited exceptions, until 1991. That section does not limit its applications to situations where baseline rates may affect low income customers.

D. Do the Contracts Provide an Unreasonable Advantage to SDG&E and SCE over other Noncore Customers?

Many parties, including DRA, TURN, CSC, CCC, Trigen, and CIG, believe the contracts compromise the Commission's efforts to adopt a comprehensive program for capacity allocation, although none objected to the use of long-term contracts in general. CSC and CIG point out that the Commission has repeatedly expressed its preference for a market-based priority charge, established by bidding. The contracts remove SoCal's largest gas loads from any market-driven program and thereby circumvent a Commission program.

DRA, Trigen, TURN, CIG, and CSC agree that the SoCal contracts provide unwarranted preferential arrangements for SDG&E and SCE which will prejudice other noncore customers seeking gas services. Trigen points out that the contracts offer two of SoCal's 800 noncore customers 20 to 25 percent of SoCal's total interstate pipeline capacity rights. SoCal's pending negotiations with other Southern California utilities would result in the allocation of almost 80 percent of SoCal's capacity prior to the development of a Commission program or an opportunity for other noncore customers to participate in the allocation process.

Similarly, according to CSC, the contracts circumvent the Commission's storage banking program by granting SDG&E and SCE long-term storage rights which are not available to other customers under the existing pilot program.

DRA also objects to the contracts because they appear to commit SoCal to construction of new capacity. DRA notes SoCal's testimony that, if a large number of noncore customer seek long-term contracts, new capacity may be required. DRA objects to contracts which commit SoCal to long-term capacity prior to the development of a capacity allocation program.

Finally, DRA believes other noncore customers will be harmed by the contracts because significant risk to SoCal is reduced, thereby providing SoCal with additional leverage in its negotiations with noncore customers who negotiate for services in the future.

SoCal does not believe the contracts provide an unfair advantage to SCE and SDG&E over other noncore customers. Other noncore customers may negotiate similar contracts for packages of gas services at a later time. SoCal chose to negotiate first with SCE and SDG&E because they are its two largest noncore customers and because both are utilities with public service obligations.

SCE asserts that approval of the contracts will not prejudice the outcome of the capacity allocation proceedings, and the Commission's decision to review the contracts in advance of hearings in R.88-08-018 is appropriate.

SDG&E argues that its contract with SoCal reflects its unique position as a local distribution company with special responsibility to serve its customers, a responsibility which retail customers do not have. It cites D.86-12-009, in which we found that "(w)holesale customers are unique because their customer gas has both core and non-core elements, and due to the fact that they impose fewer costs on the primary utility than do retail customers." The contract with SoCal allows SDG&E to fulfill its utility responsibility by eliminating the inferior quality of service provided SDG&E compared with SoCal and Pacific Gas and Electric Company (PG&E). SCE makes similar points regarding its obligations as a public utility.

Discussion: Although approval of the contracts may favor two SoCal noncore customers over others, the contracts may be reasonable if SDG&E and SCE have a utility obligation which distinguishes them from other noncore customers and competitors. Clearly, both SDG&E and SCE have such a utility obligation. With respect to SDG&E, it has long been the wish of this Commission to see SDG&E negotiate an agreement with SoCal that would afford it access to firm capacity and storage service in order to allow it to meet its own independent utility obligations, especially to the core.

Despite the Commission's intentions with respect to long-term contracts for SCE and SDG&E, we are concerned that our approval of the contracts before us could prejudge the implementation of our capacity allocation program. The contracts commit significant capacity to two major customers before the development of a pipeline allocation program. While we conclude that these contracts do not provide an unreasonable advantage to SCE and SDG&E over other noncore customers, the contracts may thwart our efforts to establish a final capacity brokering program. We will therefore require that some amount of the firm capacity allocated under these contracts be recallable by subsequent decisions of the Commission in the establishment of a capacity allocation program. By "recallable" we mean that the capacity, now allocated for use by SCE and SDG&E, will be available for allocation to others should the circumstances in the capacity brokering program warrant.

E. Are the Contracts Fair and Reasonable to SoCal Ratepayers?

We next need to consider whether the contracts are fair to SoCal ratepayers, and whether those contracts are needed to prevent uneconomic bypass or fuel-switching.

SoCal estimates a revenue shortfall from the contracts of about $23.2 million for the SDG&E contract and about $8.1 million for the SCE contract. DRA estimates the shortfall to be about $7.4 million for the SDG&E contract and $6.0 million for the SCE contract. DRA's estimate differs from SoCal's because of differing assumptions regarding revenue requirement.

SoCal believes the rates in the contracts are reasonable. Except in the first year, SCE's demand charge will be established by the Commission in SoCal's ACAPs. SDG&E's analysis of the difference between revenues at SDG&E's contract rate and at default rates over the next five years shows that SDG&E's discount will only be a few percent below default revenues, especially in 1991 and after.

SoCal argues that rate discounts are necessary because SCE and SDG&E have viable alternatives to SoCal's gas services, among them, service to SCE by the City of Long Beach, the construction of a pipeline by SCUPP, and the construction of a pipeline from the Colorado River by SDG&E. The take-or-pay obligations further assure that fuel-switching or bypass will not become an economic alternative for either SDG&E or SCE.

CIG objects to the reallocation of these costs to other ratepayers and believes the contracts eliminate risk to SoCal, risk which the Commission has determined is appropriate. Under current Commission policy, according to CIG, SoCal is at risk for revenue shortfalls resulting from discounts to the default rate which occur between ACAPs. CIG states SoCal has not offered such discounts to SCE or SDG&E prior to this time. The contracts, however, provide significant discounts to the default rate and add service improvements by way of firm interstate capacity, improved priority, storage capacity, most favored nation clauses, and a waiver of the portfolio switching ban. CIG believes that because the contracts have terms of five years or more, SoCal seeks to escape responsibility for these discounts by shifting the risk to other customers. CIG asserts that SoCal's interpretation of D.86-12-009, that SoCal is insulated from the negative effects of a negotiated discount because the discount is part of a long-term contract, is fundamentally inconsistent with the Commission's adopted regulatory structure.

CIG believes that SoCal should not be shielded from risk under long-term contracts, just as it is not shielded from risk during the short-term for rate discounts to large customers. CIG believes exceptions to this rule may be reasonable if, for example, long-term discounts were required to maintain or expand load. In this case, CIG believes SoCal has not demonstrated risk of bypass or fuel-switching. In light of this, and because SoCal has not needed to discount the default rate previously, CIG argues the passthrough of the revenue shortfall to other customers cannot be justified.

TURN shares the concern that if SoCal is able to pass along the revenue shortfall from discounting, it will have no incentive to minimize the discounts. On the other hand, SoCal has shielded shareholder risk by trading off the discounts absorbed by ratepayers for a 90 percent transport-or-pay condition. TURN suggests the Commission direct SoCal to enter into long-term core transmission service agreements with its wholesale customers for their core loads in recognition of the need for stable core gas supplies.

DRA makes similar arguments and believes the contracts violate Commission orders prohibiting core election when the core portfolio is priced lower than the noncore portfolio. The prohibition was established to preclude a situation where increased gas purchases to serve a larger core group increase the core portfolio rate.

DRA also believes that SDG&E entered into the contracts as a way to circumvent the Commission's decisions in SoCal's ACAP. It notes SDG&E testimony stating that the cost allocation methodology applied to SDG&E in the SoCal ACAP resulted in costs which were higher than SDG&E felt they should have been.

Discussion. To summarize the essential elements of these contracts: in return for the minimum charge provisions of these contracts and the associated revenue stability of those terms, SoCal offered to SCE and SDG&E improved access to firm interstate capacity, improved access to storage banking and discounts from default tariffs. This was done, in general, to mitigate against the threat of uneconomic bypass or fuel switching by SCE and SDG&E and to obtain a solid commitment by SCE and SDG&E to pay their fair share of transition costs. The utilities state the contracts benefit SoCal ratepayers by mitigating against bypass, by providing revenue stability, and by committing SDG&E and SCE to pay their fair share of transition costs.

A threshold question in this proceeding is whether the contract terms are needed to avert uneconomic bypass. If they are, SoCal's ratepayers will benefit from the contracts by retaining some contribution to rates.

However, neither SoCal, SCE, nor SDG&E have provided any convincing analysis to support the claim that the contracts are needed to prevent uneconomic bypass or fuel-switching. Pipeline construction may be an option, but the record does not demonstrate whether it is an economic option for SCUPP or SDG&E. SoCal testified that SCE burned fuel oil last winter, but we have no information regarding the circumstances which made fuel-switching economic. Although SoCal's witness testified that he had undertaken a bypass study, the study was not presented on the record, and we are therefore unsure whether its methods and conclusions are reasonable.

While the Commission is concerned about the potential for uneconomic bypass and seeks to avoid it where possible, proof of the threat is necessary for the Commission to approve discounted rates and the resulting cost shift to other ratepayer classes. In this case, it is clear that no conclusive demonstration of the bypass threat for SCE and SDG&E exists. While a number of options may be available to the utilities, the efficiency of these alternatives has not been demonstrated sufficiently to allow us to approve discounted rates for SCE and SDG&E.

Thus, in this particular case we are not convinced that the discounts SoCal negotiated with SDG&E and SCE are in fact reasonable. Essentially, SCE and SDG&E are receiving a premium service (improved access to storage and firm capacity) at a discounted rate. If the justification, the potential bypass of the two larget customers of SoCal, were more conclusive we might be persuaded that the discounts as negotiated are reasonable.

We are not, however, willing to reject the premium service components of the contract. The contracts, without the discounts, represent reasonable long-term capacity brokering and storage banking services for two important customers with their own utility obligations. Our only concerns with these long-term services, that they might adversely affect our final capacity brokering program, have been addressed by the recall conditions we will place on approval of the contracts.

In regard to the waiver of the portfolio switching ban for SDG&E and SCE, we have seen no legitimate justification for this waiver. We thus reject this portion of the contracts.

F. Are the Contracts Consistent with State Law and Commission Policy Regarding Cogeneration Rates?

SoCal asserts that the contracts are consistent with the Commission's policies toward cogenerators because SoCal is willing to negotiate special agreements with cogeneration customers under similar terms and conditions as Edison has obtained. SoCal notes that four cogeneration customers have already signed long-term contracts with SoCal. SDG&E makes similar points.

SCE goes further by asserting that cogenerators are not satisfied with rate parity, which SoCal is willing to offer by negotiating similar terms and conditions for similarly situated cogeneration customers. Cogenerators, according to SCE, want additional subsidies. SCE believes the Commission's existing policy goes beyond the requirements of § 454.4 by basing cogenerator rates on the average UEG rate with higher priority than UEG customers. SCE comments that the contract's provision increasing its priority to P-3 will not reduce service levels to other customers because SoCal expects no curtailments for P-1 through P-4 customers during the contract period.

The cogeneration customers object to the contracts on the grounds that they violate §§ 454.4 and 454.7 of the PU Code, which provide generally that cogenerators shall have the highest possible priority for the purchase of natural gas at rates not higher than the established UEG rate. These provisions were enacted in recognition of the efficiencies of cogeneration facilities and the associated benefits to all Californians.

According to CSC and CCC, the contracts violate these provisions by significantly increasing SCE's P-3 volumes. They are also violated, according to CSC, because the contracts' bundled rates for a range of services are below the current transportation-only rate. CSC contends that SoCal's offer to negotiate similar contracts with customers who are similarly-situated violates the Commission's policy that cogenerators are to be treated equally and that they are to receive rates no higher than UEG rates, notwithstanding their situation. CSC points out that SoCal's witness could identify only one cogeneration customer who might qualify for a package similar to SCE's.

Similarly, CCC argues that SoCal's offer to negotiate contracts with cogenerators is unacceptable. SoCal testified that it would not consider offering rates or service similar to those in the proposed contracts unless cogenerators demonstrated the same "market conditions" faced by SCE and SDG&E. CCC believes cogeneration customers cannot demonstrate such market conditions and could therefore not realize rate parity with UEGs as required by law.

CCC and CSC believe that if the Commission approves the contracts, it must also require that SoCal offer the same rates and services to cogenerators as are offered to UEGs under the contracts. These concessions must be made, under §§ 454.4 and 454.7, regardless of whether cogenerators enter into contracts with SoCal and regardless of whether they are identically situated to SCE and SDG&E. All rates should be unbundled. SoCal should also be required to curtail UEG customers ahead of cogenerators.

Trigen proposes the Commission defer contract approval until other noncore customers and marketers are given the opportunity to enter into similar contracts.

Finally, CSC argues that SoCal cannot, as it proposes, fail to include the Edison contract rate in determining the average UEG rate used to calculate the rate to cogenerators. Such failure would be a clear violation of § 454.4.

Discussion. It appears to us that with regard to the effect of these contracts on cogenerators there are two issues: rate parity and priority. With respect to rate parity, the elimination of the discounts given to SCE and SDG&E, which we would require as a condition for contract approval, obviates the need to address this issue.

With regard to cogenerator priority, section 454.7 states:

> "The Commission shall, to the extent permitted by federal law and consistent with Section 2771, provide

> cogeneration technology projects with the highest possible priority for the purchase of natural gas."

Section 2771 allows the Commission to establish service priorities based on its determination of which customers and uses "provide the most important public benefits and serve the greatest public need."

It is clear that the SoCal contracts intend to provide for a priority level at least equal to the priority level established for cogenerators for about 90 percent of SDG&E's load and about half of SCE's load. Although SoCal's witness testified that SoCal does not expect curtailments above P-5 during the contract period, it offered no specific analysis or evidence to support that claim. In fact, that view appears inconsistent with SoCal's testimony that both pipeline capacity and natural gas may be in shorter supply in the future, especially since the contracts would add significant additional volumes to the P-3 category. Moreover, we wonder why the UEGs must be assigned a priority level higher than cogenerators if SoCal does not expect to curtail any customers above the P-5 level.

We could permit higher priority for UEGs under § 2771, but we would first need to find that the UEGs provide more important public benefits than cogenerators. We see no compelling reason to do so at this time. Without such a finding, the contracts as written are inconsistent with § 454.7.

We do not reject the upgrade of priority for the stated volumes to P-3. However, it is clear that whatever priority is established for UEG volumes, cogenerators must receive a higher priority than UEG customers within their respective service territories. In addition, consistent with SDG&E's wish for independent status, the parties should investigate methods for achieving SDG&E's goal of independent status from SoCal. We encourage acceptable contract language to be negotiated by SoCal with SCE and SDG&E.

III. Conclusions

To conclude, the contracts as filed are rejected. However, the Commission will approve new contracts modified to meet the following conditions. First, the transportation rate discounts should be eliminated. Second, a certain proportion of the firm interstate capacity rights SCE and SDG&E are to receive under the contracts, to be negotiated by the parties, is to be recallable by the Commission in the capacity brokering order. This is in order to insure that the Commission's final capacity brokering program is not unduly harmed by such long-term contracts. The Commission will give suitable notice to SoCal, SCE and SDG&E of the recall action in a formal Commission decision or resolution. Third, priority for cogenerators will continue to be higher than that for UEG. Finally, the waiver of the portfolio switching ban should be eliminated from the contracts.

One unaddressed issue concerns the level of take-or-pay obligation that SCE and SDG&E still must incur despite the elimination of the rate discounts. The contracts currently have provisions for a 90% take-or-pay obligation on the part of SCE and SDG&E. In its comments to the ALJ proposed decision, SCE stated its position that if the discounts were to be eliminated, a 70% take-or-pay obligation would be appropriate. We are not convinced. As this decision indicates, the minimum charge provision of the contracts was a quid pro quo for the firm capacity and storage volumes as well as the rate discounts. While the elimination of the discounts certainly reduces the benefits of this agreement for SCE and SDG&E, access to firm capacity and storage banking is still a tremendous benefit to these customers, as they themselves argued during the hearings.

Further negotiations on a final take-or-pay level and on the amount of capacity to be recallable at a future date by the Commission are necessary. It should be clear from the previous discussion that the final take-or-pay level for SCE should be between 70% and 90%; the final take-or-pay level for SDG&E may be different from that for SCE if circumstances warrant. For recallable capacity, at least one-third of the capacity to be used for non-core customers must be recallable, about 60 MMcfd for SDG&E and 100 MMcfd for SCE.

If these conditions are acceptable to SoCal, SDG&E and SCE, SoCal should file amended contracts that conform to today's decision by advice letter within 90 days.

Generally, this decision affirms our belief that long-term contracts are appropriate under certain circumstances. They are primarily useful where a customer must make a decision regarding whether or not to invest in bypass facilities and such facilities would clearly result in uneconomic bypass from the utility's system.

As we have mentioned earlier, and as evidenced by our rejection of the rate discounts contained in these contracts, we are not satisfied with the demonstration of the uneconomic bypass threat made by SoCal in this proceeding. In the future, unless SoCal can clearly demonstrate the necessity of a long-term contract to avoid uneconomic bypass, we will not allocate to other SoCal ratepayers revenue shortfalls associated with those contracts. Without such proof, and in the absence of some type of risk-sharing mechanism, we believe that SoCal may be inclined to sign long-term contracts with all of its major customers. This circumstance would turn our new regulatory program--which was designed to promote competition and more efficient utility management--on its head. As we have stated earlier in the decision, special circumstances exist for these two large investor-owned utilities that justify the approval of some terms of this contract.

An increased number of long-term contracts could be damaging to other participants in the markets for storage and pipeline capacity if they commit a significant amount of these services. Long-term contracts commit significant capacity to specific customers at negotiated rates, while other noncore customers may have to bid for capacity based on their value of service. This may not be a problem prior to the establishment of a pipeline capacity allocation program if it can be demonstrated that a contract is required to forestall bypass which is economic for the customer and addresses the other concerns raised in this decision.

Findings of Fact

1. SoCal has applied for approval of long-term gas service contracts with SDG&E and SCE. The contracts provide discounted rates for a full range of natural gas services, including storage, transportation, and firm pipeline capacity.

2. D.86-12-009 stated that the utilities may negotiate long-term contracts to encourage the utilities to attract incremental load which might otherwise be lost.

3. Since the issuance of D.86-12-009, the Commission has reduced default transportation rates, developed a pilot storage banking program, and stated its intention to establish a pipeline capacity allocation program, all of which tend to reduce the risk of uneconomic bypass of the gas utilities' systems.

4. No party to this proceeding argued that the contracts would harm the ratepayers of SCE or SDG&E.

5. D.86-12-009 stated that utility shareholders may be liable in reasonableness reviews for revenue shortfalls from long-term contracts if the utility does not maximize contract revenue based on material information that was or should have been known at the time the long-term contract was signed. That decision expressly prohibits reallocating revenue shortfalls associated with short term contracts.

6. Other noncore customers have not had an opportunity to negotiate contracts or bid for the range of services the contracts offer SCE and SDG&E.

7. SCE and SDG&E have utility obligations which other, non-UEG customers do not have.

8. The record does not demonstrate that the contracts are required in order to prevent uneconomic bypass or fuel-switching.

9. The contract terms which permit portfolio switching are contrary to the rule which prohibits portfolio switching and which applies to all other noncore customers.

10. The contracts provide for service priority for significant volumes of UEG gas which is higher than the priority offered to cogenerators.

11. Long-term contracts may be required to prevent uneconomic bypass or fuel switching.

Conclusions of Law

1. Nothing in this decision should be construed as a finding of reasonableness regarding SCE or SDG&E's decisions to sign the subject contracts with SoCal.

2. D.86-12-009 assumed that revenue shortfalls from long-term contracts may be allocated to ratepayers. Therefore, the Commission would be in compliance with § 739.6 if it allocated revenue shortfalls associated with SoCal's contracts to SoCal customers.

3. Section 739.6 would not be violated if the Commission reallocated revenue shortfalls resulting from a long-term contract to SoCal ratepayers if the contract was required to prevent harm to ratepayers resulting from significant revenue losses associated with uneconomic bypass, because such reallocation was intended in D.86-12-009.

4. Section 739.6 would not be violated if the Commission reallocated revenue requirement between the residential gas

ratepayers of two regulated utilities, if that reallocation sought to redress inequities between those two groups of ratepayers.

5. The application of § 739.6 is not limited to situations whereby baseline rate design affects the rates of low-income customers.

6. Section 454.4 requires that cogenerators are offered rates no higher than those offered by a gas utility to UEG customers in the gas utility's service territory.

7. Section 454.7 requires that cogenerators receive the highest possible priority for the purchase of natural gas.

8. The waiver of the portfolio switching ban is inconsistent with current Commission policy and is thus unreasonable.

9. The discounts offered in the contracts are not reasonable.

10. The Commission should deny SoCal's request for approval of its long-term contracts with SCE and SDG&E.

11. The Commission should consider approving a renegotiated contract between SDG&E and SoCal which (1) does not offer discounts (2) provides for some portion of firm capacity to be recallable by the Commission (3) provides for the curtailment of contract volumes before cogenerator volumes, and (4) does not waive the portfolio switching ban. They should also renegotiate the take-or-pay provisions of the contract and decide on the amount of firm capacity to be recallable by the Commission at a later date.

12. The Commission should consider approving a renegotiated contract between SCE and SoCal which (1) does not offer discounts (2) provides for some portion of firm capacity to be recallable by the Commission (3) provides for the curtailment of contract volumes before cogenerator volumes, and (4) does not waive the portfolio switching ban. They should also renegotiate the take-or-pay provisions of the contract and decide on the amount of firm capacity to be recallable by the Commission at a later date.

13. If the parties renegotiate their contracts pursuant to Conclusions of Law 12 and 13, SoCal shall file advice letters seeking approval of the amended contracts. The advice letter(s) should be filed within 90 days of the effective date of this order and should be served on all parties to this proceeding.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company's (SoCal) request for approval of its contract with Southern California Edison Company (SCE) is denied.

2. Southern California Gas Company's (SoCal) request for approval of its contract with San Diego Gas and Electric (SDG&E) is denied.

3. SoCal may file for approval of an advice letter which would establish the terms and conditions of an amended contract with SCE. The contract shall be amended pursuant to this decision. The advice letter shall be served on all parties to this proceeding.

4. SoCal may file for approval of an advice letter which would establish the terms and conditions of an amended contract with SDG&E. The contract shall be amended pursuant to this decision. the advice letter shall be served on all parties to this proceeding.

This order is effective today.

Dated ________________, at San Francisco, California.